Office - Supreme Court, U.S
FILED
MAR 28 1984
ALEXANDER L. STEVAS
CLERK

No. 83-1412

In the Supreme Court of the United States

OCTOBER TERM, 1983

CITY OF CAMBRIDGE, MASSACHUSETTS,
PETITIONER,

v.

ROBERT W. MESERVE and BENJAMIN H. LACY,
REORGANIZATION TRUSTEES OF THE
BOSTON AND MAINE CORPORATION,
RESPONDENTS.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF OF RESPONDENTS IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

ROBERT M. GARGILL
Counsel of Record
JOHN N. GARNER
CHOATE, HALL & STEWART
60 State Street
Boston, Massachusetts 02109
(617) 227-5020
Attorneys for Respondents

Blanchard Press, Inc., Boston, Mass.—Law Printers

I

QUESTION PRESENTED

Where in a railroad reorganization proceeding under Section 77 of the Bankruptcy Act it had been necessary for the railroad's trustees in the public interest to defer the payment of postpetition municipal real estate taxes in order to maintain railroad operations and the Reorganization Court approved that deferral, may the Court thereafter approve a reorganization plan which does not provide for payment to the municipalities of default interest accrued on the taxes so deferred while providing for payment of contract interest on the claims of mortgage bondholders, if an analysis and assessment of the facts and equities pertinent to the treatment of all creditors under the plan reasonably support the Court's approval of the plan?

PARTIES

Respondents Robert W. Meserve and Benjamin H. Lacy (the "Trustees") are the Reorganization Trustees of the estate of the Boston and Maine Corporation (the "Railroad" or "Debtor").

Petitioner the City of Cambridge, Massachusetts (the "City") is a political subdivision of the Commonwealth of Massachusetts.

TABLE OF CONTENTS

	Page
Question Presented	I
Parties	I
Table of Contents	III
Table of Authorities	IV
Counterstatement of the Case	1
Reasons for Denying the Writ of Certiorari	7
I. The Court of Appeals' Affirmance of the Reorganization Court's Decision That the City Had No Legal or Equitable Right to Postpetition Interest on Postpetition Taxes Is Consistent With the Decisions of This Court and Other Federal Courts and Is Correct	7
A. Allowance of Interest on Postpetition Taxes Is Not Mandated as a Matter of Law, but Is Subject to the Exercise of the Reorganization Court's Equity Powers	7
B. This Court's Decision in *Nicholas* Is Not Inconsistent With the Decision Below	11
C. The Court of Appeals Properly Affirmed the Reorganization Court's Disallowance on Equitable Grounds of the City's Claim for Postpetition Interest	18
D. The Court of Appeals Properly Affirmed the Reorganization Court's Ruling That the Plan's Denial of Postpetition Interest Did Not Violate the Absolute Priority Rule or Principles of *Fosdick* v. *Schall*	22
II. The Petition Does Not Represent an Issue Likely To Recur	23
Conclusion	25

Table of Authorities

Cases

Page

In re Boston and Maine Corp., 634 F.2d 1359 (1st Cir. 1980), *cert. denied*, 450 U.S. 982 (1981) 22

Boston & Maine Corp. v. *First National Bank of Boston*, 618 F.2d 137 (1st Cir. 1980) 3

City of Cambridge v. *Robert W. Meserve and Benjamin H. Lacy, Reorganization Trustees of the Boston and Maine Corp.*, 693 F.2d 4 (1st Cir. 1982) 3, 9

Consolidated Rock Products Co. v. *DuBois*, 312 U.S. 510 (1941) 22

Continental Illinois National Bank & Trust Co. v. *Chicago, Rock Island & Pacific Railway Co.*, 294 U.S. 648 (1935) 17

Fosdick v. *Schall*, 99 U.S. 235 (1879) 22

In re H&C Enterprises, 35 B.R. 352 (Bkrtcy. D. Idaho, 1983) 25

Heiser v. *Woodruff*, 327 U.S. 726 (1946) 10

In re Leeds Homes, Inc., 222 F.Supp. 20, (E.D. Tenn. 1963), *aff'd* 332 F.2d 648 (6th Cir. 1964), *cert. denied*, 379 U.S. 836 (1964) 11

In re Magnus Harmonica Corp., 262 F.2d 515 (3d Cir. 1959) 11

In re New York, New Haven and Hartford Railroad Co., 304 F.Supp. 1121 (D. Conn. 1969) 11, 17-18

In re New York, New Haven and Hartford Railroad Co., 4 B.R. 758 (D. Conn. 1980) 22

In re New York, Ontario & Western Railway Co., 25 F. Supp. 709 (S.D.N.Y. 1937) 8

New York v. *Saper*, 336 U.S. 328 (1949) 11

Nicholas v. *United States*, 384 U.S. 678 (1966) 8, 11-12, 14, 16, 17, 18, 20, 23, 25

In re Penn Central Transportation Co., 458 F.Supp. 1234 (E.D. Pa. 1978), *aff'd*, 596 F.2d 1102 (3d Cir. 1979) 8, 13

Page

In re Penn Central Transportation Co., 325 F.Supp. 294 (E.D. Pa. 1970), *aff'd*, 452 F.2d 1107 (3d Cir. 1971), *cert. denied*, 406 U.S. 944 (1972) 9, 14

Pepper v. *Litton*, 308 U.S. 295 (1939) 10

Sexton v. *Dreyfus*, 219 U.S. 339 (1911) 11

In re Stack Steel & Supply Co., 28 B.R. 151 (Bkrtcy. W.D. Wash. 1983) 23-25

Vanston Bondholders Protective Comm. v. *Green*, 329 U.S. 156 (1946) 10, 11, 14-15, 16, 20

Statutes

Bankruptcy Act,

Section 64, 11 U.S.C. §104 (1977) (repealed) 8-9, 10

Section 64a(1), 11 U.S.C. §104a(1) (1977) (repealed) 8

Section 77, 11 U.S.C. §205 (1977) (repealed) ..... I, 1, 8-9, 17

Section 77(b), 11 U.S.C. §205(b) (1977) (repealed) 9

Section 77(c)(6), 11 U.S.C. §205(c)(6) (1977) (repealed) 17

Section 77(e), 11 U.S.C. §205(e) (1977) (repealed) 6

Section 77(l), 11 U.S.C. §205(l) (1977) (repealed) 9

Section 77(n), 11 U.S.C. §205(n) (1977) (repealed) 9

Section 77(o), 11 U.S.C. §205(o) (1977) (repealed) 17

Bankruptcy Code,

Section 503, 11 U.S.C. §503 (1978) 23, 25

Mass. Stat. 1933, c. 151 6

Mass. Stat. 1976, c. 101 6

Mass. Stat. 1979, c. 503 6

Treatises

5 *Collier on Bankruptcy* ¶77.21 (14th ed. 1978) 8

In the
Supreme Court of the United States

OCTOBER TERM, 1983

No. 83-1412

CITY OF CAMBRIDGE, MASSACHUSETTS,
PETITIONER,

v.

ROBERT W. MESERVE and BENJAMIN H. LACY,
REORGANIZATION TRUSTEES OF THE
BOSTON AND MAINE CORPORATION,
RESPONDENTS.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF OF RESPONDENTS IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

The Trustees respectfully submit this brief in opposition to the petition for a Writ of Certiorari filed herein by the City.

Counterstatement of the Case

On March 12, 1970, an involuntary petition was filed against the Railroad under Section 77 of the Bankruptcy Act, 11 U.S.C. §205 (1977) (repealed)[1] in the United States District

[1] Repealed by the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549, *et seq.*, but controlling as to the Railroad's reorganization proceeding.

Court for the District of Massachusetts (the "Reorganization Court"). That petition was thereafter approved by the Reorganization Court and the Trustees were appointed as such by Order dated April 24, 1970.

As the record below established, the Trustees did not have in the course of the reorganization proceeding sufficient cash available to pay both current operating expenses indispensable to the continued operation of the railroad and current taxes. (P. App. 55).[2] Indeed, at any given time throughout the reorganization period, the Trustees' unencumbered cash was sufficient to cover only several days' operating expenses, exclusive of taxes. On May 29, 1975, the Trustees formally sought the Reorganization Court's approval for the deferral of tax payments.[3]

On September 19, 1978, the Reorganization Court entered Order No. 291, which, among other things, authorized the Trustees to defer the payment of taxes "heretofore or hereafter assessed on or in connection with property of or in the possession of the Debtor or the Trustees, except such payments as are made pursuant to settlements authorized by this court; . . . ." Order No. 291 was based on a finding by the Reorganization Court that:

> [T]he railroad revenues and cash position are such that the payment of taxes other than pursuant to settlements proposed by the Trustees would impair feasible operations of the railroad.

The City and other taxing authorities initially appealed from this Order but withdrew their appeals upon a clarifying ruling by the Reorganization Court that the Order's injunction against and invalidation of tax foreclosures would not prejudice the perfection of any valid tax lien.

---

[2] References to "P. App." are to the Appendix to the Petition for Certiorari.

[3] The City incorrectly alleges that the Reorganization Trustees did not apply for such an order until 1978. (The City's Petition, at p. 8)

On July 8, 1981, the City filed an application to terminate the deferral of tax payments. On February 22, 1982, the Reorganization Court issued a Memorandum and Order denying the City's application, again concluding that the Trustees lacked sufficient cash to make the payments demanded by the City. The City appealed the order and the First Circuit Court of Appeals affirmed the same. *City of Cambridge* v. *Robert W. Meserve and Benjamin H. Lacy, Reorganization Trustees of the Boston and Maine Corp.*, 693 F.2d 4 (1st Cir. 1982).

On April 28, 1982, the Interstate Commerce Commission approved the Trustees' Amended Plan of Reorganization (the "Plan"). The Plan had been filed on December 12, 1975, and had been amended from time to time through February 5, 1982. The first step of the Plan called for the Trustees' sale to the Massachusetts Bay Transportation Authority of the Railroad's commuter rail properties. The sale was consummated at the end of 1976. The next step involved a tender by the Trustees for the major portion of the Railroad's outstanding First Mortgage Bonds at a price equal to 80% of the principal amount thereof, without interest. *See Boston & Maine Corp.* v. *First National Bank of Boston*, 618 F.2d 137 (1st Cir. 1980). This resulted in the redemption in 1979 of approximately 78.5% of the then outstanding First Mortgage Bonds. Each of these actions had been approved by the Interstate Commerce Commission and the Reorganization Court without objection by the City. The Plan's third phase provided for the settlement and satisfaction of claims against and interests in the Debtor's estate in conjunction with the acquisition of the reorganized Debtor by Guilford Transportation Industries, Inc. ("Guilford"). Here, the Plan provided, *inter alia*, for the following:

1. The establishment of a limited fund (the "Segregated Account") out of which creditors' claims are to be settled and satisfied after setting aside $5,250,000 as working capital for

the reorganized company. The Segregated Account consists primarily of the $24,250,000 to be put up by Guilford and certain funds on deposit in restricted accounts which primarily constitute the proceeds of sale of mortgaged property. Such funds amounted to approximately $47,970,000 on June 30, 1982.

2. The payment in full but without interest of all administrative claims, including postpetition tax claims, but excluding claims of the United States of America in respect of $26,000,000 of Trustees' certificates dated September 29, 1978 evidencing the Trustees' postpetition loan obligation to the Federal Railroad Administration. These certificates are to be converted to preferred stock in the reorganized company.

3. The payment in full but without interest of all prepetition secured tax claims and so-called Six-Months claims.

4. The payment in full of the Debtor's remaining First Mortgage Bonds with accrued interest at the contract rate of 6% per annum and of the Debtor's Income (second mortgage) Bonds with accrued interest at the contract rate of 4% per annum. However, to the extent that on the Consummation Date there is insufficient cash to make such payment on the Income Bonds, the holders thereof will receive Series A CCI's (certificates of contingent interest) in an amount equal to the unpaid balance of principal and interest payable on those Bonds.

5. The United States in respect of certain claims and the holders of unsecured prepetition tax claims are to receive, respectively, Series B and Series C CCI's in the full amount of their allowed claims, without interest.

6. Lastly, general unsecured creditors are to receive Series D CCI's in an amount equal to 10% of the allowed amount of their claims, without interest.

The four series of CCI's are non-interest bearing and are payable only out of the Segregated Account to the extent that there are funds in that amount in excess of what is necessary to pay claims enjoying higher priority.

Among themselves the CCI's are to be payable in the order of their respective priority from time to time when it is determined that such excess cash is available. If the CCI's have not been paid in full within five years after the Consummation Date, they are automatically cancelled, and the holders will have no further claims on account of any unpaid balance thereof.

As the Railroad is insolvent, the Plan provides no payment for or distribution on its preferred or common stock.

On July 15, 1982, prior to the Reorganization Court's hearing on approval of the Plan, the Trustees filed an application for a determination that the estate was not liable to pay interest on tax claims. On August 2, 1982, the City filed a statement in opposition to the application. On August 5, 1982, that application was heard and evidence was introduced with respect to the same.

On August 11 and 12, 1982, the Reorganization Court held hearings on the question of approval of the Plan, which had been approved and certified to it by the Interstate Commerce Commission. The Reorganization Court incorporated the record of the August 5 hearing into the record of the August 11 and 12 hearing on approval of the Plan. The City participated in this hearing, opposing the Court's approval of the Plan because it provided for no postpetition interest on its tax claims.

Through December 31, 1981, postpetition interest claimed by all taxing authorities amounted to approximately $600,000 on prepetition taxes and approximately $2.3 million on postpetition taxes. At the date of the interest hearing on August 5, 1982, the City claimed postpetition interest of $375,000 on its prepetition tax claim and $1,868,000 on postpetition taxes.

The interest claimed is sought to be imposed under state statutes which require its payment on and as a consequence of the taxpayer's default in payment of the taxes by the due dates prescribed by those statutes. It is default or penalty interest

and is described as such in several of the statutes establishing the rate of interest payable.[4]

The record below established that the City's taxes were assessed on undeveloped land and a number of buildings, the only significant one of which is a rubbish disposal facility owned by a lessee of a portion of the Railroad's land. A substantial part of the taxes assessed against the Railroad and the estate in reorganization were levied to support municipal schools. In the case of the City, the tax bills indicate that in excess of 40% of the taxes levied were for support of schools. None of the taxes owed by the Railroad or the Trustees arose with respect to residential property.

The cumulative operating loss from railroad operations in the period 1970-1981 was $47.7 million. Even if the operating expenses consisting of property taxes were deducted from this figure, there would still have been a cumulative deficit for the period of $28.5 million.

On December 30, 1982, the Reorganization Court issued an Order approving the Plan, ruling that it complied with the requirements of §77(e). On February 24, 1983, the Reorganization Court issued an opinion in support of the Order. (P. App. 30).

In approving the Plan, the Court denied the objections of the City and other municipalities to the Plan's disallowance of their claims for postpetition interest on prepetition and postpetition taxes. In its opinion, the Court found: that "during the period of reorganization sufficient cash has not been available to pay current taxes and all necessary current operating expenses indispensable to continued rail operation"; that the delay in payment of taxes must be viewed as a delay necessitated by law; that it was unlikely that there would be any surplus cash with which to pay interest on taxes over and above what was needed to make payments to other creditors under the Plan; that payment of interest on the City's pre-

[4] Mass. St. 1970, c. 505; Mass. St. 1976, c. 101; Mass. St. 1933, c. 151.

petition and postpetition tax claims "would diminish the distributive shares of general creditors through no fault of theirs, and would have the effect of penalizing them"; that the allowance of the postpetition interest claimed would not accord with equitable principles; that the disallowance of such interest does not violate the absolute priority rule; and that the estate is insolvent. (P. App. 55-7, 45).

The City appealed the Reorganization Court's order approving the Plan to the First Circuit Court of Appeals. In a decision entered on September 30, 1983, the Court of Appeals entered a judgment affirming the Reorganization Court's order. (P. App. 13-29). The City then petitioned for a rehearing en banc, which was denied on November 17, 1983. (P. App. 72).

The Plan was consummated on June 28, 1983. The Trustees have since paid the City the full principal amount of the prepetition and postpetition taxes owed it. The Reorganization Court's consummation order provides that the Trustees shall hold in escrow an amount sufficient to pay the interest the City alleges is owed on its tax claims pending final resolution of its appeal.

Reasons for Denying the Writ of Certiorari

I. THE COURT OF APPEALS' AFFIRMANCE OF THE REORGANIZATION COURT'S DECISION THAT THE CITY HAD NO LEGAL OR EQUITABLE RIGHT TO POSTPETITION INTEREST ON POSTPETITION TAXES IS CONSISTENT WITH THE DECISIONS OF THIS COURT AND OTHER FEDERAL COURTS AND IS CORRECT.

A. *Allowance of Interest on Postpetition Taxes Is Not Mandated as a Matter of Law, but Is Subject to the Exercise of the Reorganization Court's Equity Powers.*

The City suggests that interest on postpetition taxes must be allowed in a railroad reorganization proceeding wholly apart from the equities of the matter. This is not the case. The City appears to rest its contention on the asserted applicability of

§64a(1) of the Bankruptcy Act, 11 U.S.C. §104a(1) (1977) (repealed), in railroad reorganization proceedings and this Court's decision in *Nicholas* v. *United States*, 384 U.S. 678 (1966) ("*Nicholas*").

Section 64 establishes priorities "in advance of the payment of dividends to creditors," and clause (1) thereof accords a first priority to, *inter alia*, "the costs and expenses of administration, including the actual and necessary costs and expenses of preserving the estate subsequent to filing the petition; . . . ."

Section 64 is not generally regarded as applicable in §77 proceedings.

> It is extremely doubtful, however, if §64, governing priorities in ordinary bankruptcy, can be considered generally applicable. The classification of priorities there set forth is not adaptable to railroad reorganization, and the fact that the section itself refers to certain debtor rehabilitation proceedings other than railroad reorganization may be taken as indicative of its general non-applicability. It has been said that "the matter of priority in railroad reorganizations is governed by equity receivership rules."

5 *Collier on Bankruptcy* ¶77.21, at 608-09 (14th ed. 1978) (footnotes omitted).

Collier goes on to acknowledge that §64 has been given "some controlling effect" as to tax claims. *Id.* at 609. However, the first case cited in support of this comment indicates that the applicability of the section is subject to the sound discretion of the court, *In re New York, Ontario & Western Railway Co.*, 25 F. Supp. 709, 713 (S.D.N.Y. 1937); and the second case treats the section as establishing guidelines for the exercise of the court's equitable power. *In re Penn Central Transportation Co.*, 458 F. Supp. 1234 (E.D. Pa. 1978), *aff'd*, 596 F.2d 1102 (3d Cir. 1979).

Given the primacy of the public interest in a railroad reorganization case, the complexity of the issues involved and

the provisions of the statute itself, §64 cannot properly be regarded as controlling. Section 77 contains specific variances from the distributive provisions of §64. Thus, §77(b) accords priority to unsecured claims which would have enjoyed priority in federal equity receiverships. Section 77(n) accords priority for employee personal injury claims. The case law also establishes priorities between prepetition mortgagees and postpetition suppliers of services necessary to the railroad's operation which are inconsistent with ordinary bankruptcy priorities. Moreover, the generally accepted power of the Court to defer the payment of postpetition taxes[8] itself reinforces the conclusion that §64 is not controlling in §77 proceedings. That power reflects a recognition that, when the public interest requires continued operation of the railroad and there is insufficient cash available to satisfy all expenses of administration, there is a need to distinguish between those expenses which are indispensable to continued operation such as employee, fuel, utility and equipment costs, and those that are not. In this context, administration expense claims that would be treated similarly in an ordinary bankruptcy may be treated differently in a railroad reorganization case.[9]

Section 77(1) does not, as suggested by the City, make §64 applicable in railroad reorganization proceedings, as by its terms, provisions governing ordinary bankruptcy are to be applied only to the extent consistent with the other provisions of §77. As above indicated, those other provisions, as well as the nature of the proceeding, make §64 inapplicable.

Wholly apart from the foregoing, even if taxes are an expense of administration in the ordinary bankruptcy case and in

---

[8] *City of Cambridge* v. *Robert W. Meserve and Benjamin H. Lacy, Reorganization Trustees of the Boston and Maine Corp.*, 693 F.2d 4 (1st Cir. 1982); *In re Penn Central Transportation Co.*, 335 F. Supp. 294, 299-300 (E.D. Pa. 1970), *aff'd*, 452 F.2d 1107 (3rd Cir. 1971), *cert. denied*, 406 U.S. 944 (1972).

[9] As discussed below, this is not a harsh result for the municipalities since, among other things, it is the public interest as represented by them that is served by continued operation of the railroad.

a railroad reorganization proceeding, §64 does not by its terms mandate that interest on claims for administration expenses also be treated as expenses of administration.

The fact that under state law there may exist a legal obligation to pay interest is not controlling as to whether that interest must be paid in a bankruptcy or reorganization proceeding. Federal bankruptcy law is controlling as to priorities and distributions among creditors. *Vanston Bondholders Protective Comm.* v. *Green*, 329 U.S. 156, 162 (1946); *Heiser* v. *Woodruff*, 327 U.S. 726, 732 (1946). Furthermore, as the Court of Appeals noted, "the district court, in passing on the allowance of claims, sits as a court of equity. *Pepper* v. *Litton*, 308 U.S. 295, 307 (1939); *see Sampsell* v. *Imperial Paper & Color Corp.*, 313 U.S. 215, 219 (1941)." (P. App. 14).

> Consequently this Court has held that for many purposes "courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity." By virtue of §2 a bankruptcy court is a court of equity at least in the sense that in the exercise of the jurisdiction conferred upon it by the Act, it applies the principles and rules of equity jurisprudence.
>
> . . . .
>
> By reason the express provisions of §2 these equitable powers are to be exercised on the allowance of claims, a conclusion which is fortified by §57(k). For certainly if, as provided in the latter section, a claim which has been allowed may be later "rejected in whole or in part, according to the equities of the case," disallowance or subordination in light of equitable considerations may originally be made.

Pepper v. *Litton*, 308 U.S. 295, 304-305 (1939) (citations and footnote omitted).

With respect to the specific matter of postpetition interest, it has been consistently held that the allowance of such interest is subject to the exercise by the bankruptcy court of its powers as a court of equity.

In *Vanston Bondholders Protective Comm.* v. *Green*, 329 U.S. 156 (1946), this Court stated:

> It is manifest that the touchstone of each decision on allowance of interest in bankruptcy, receivership and reorganization has been a balance of equities between creditor and creditor or between creditors and the debtor.

Id. at 165. *See In re Magnus Harmonica Corp.*, 262 F.2d 515, 518 (3d Cir. 1959); *In re Leeds Homes, Inc.*, 222 F. Supp. 20, 32-33 (E.D. Tenn. 1963), *aff'd*, 332 F.2d 648 (6th Cir. 1964), *cert. denied*, 379 U.S. 836 (1964); *New York* v. *Saper*, 336 U.S. 328 (1949); *Sexton* v. *Dreyfus*, 219 U.S. 339 (1911). This same balancing of equities is involved in a reorganization court's determination of the allowability of claims for post-petition interest on postpetition taxes. *In re New York, New Haven and Hartford Railroad Co.*, 304 F. Supp. 1121, 1134 (D. Conn. 1969). For the reasons set forth below, this Court's decision in *Nicholas* is not contrary authority.

B. *This Court's Decision in* Nicholas *Is Not Inconsistent With the Decision Below.*

The City argues that *Nicholas* requires payment of post-petition interest on postpetition taxes. In *Nicholas*, federal payroll, social security and excise taxes had accrued during the pendency of a Chapter XI case. However, those taxes did not become due until the case had been converted to a liquidating bankruptcy proceeding. As this Court noted:

> The actual arrangement proceedings in this case, however, terminated before the taxes became payable, and, therefore, no interest on the taxes accumulated before the petition in bankruptcy was filed by the debtor in possession. The entire amount of interest sought by the United States represents interest claimed for the liquidating bankruptcy period.

Id. at 689.

What was at issue in that case was whether the trustee was obligated to pay interest which had accrued subsequent to the filing of the bankruptcy petition on taxes which had accrued prior thereto during the arrangement proceeding. While the Court viewed interest accruing during an arrangement proceeding on taxes arising therein as being payable, the case provided no opportunity to assess the equities of allowing any such interest, since no interest accrued during the Chapter XI period. The Court's rationale for its view was that interest accruing during the arrangement proceeding does not arise due to a "delay" of the law in any meaningful sense, *id.* at 684, that from the vantage point of the creditor extending credit in the Chapter XI proceeding, it is only the subsequent filing of a bankruptcy petition that causes "meaningful legal delays," *id.* at 685, and that the allowance of such interest promotes the availability of capital to a Chapter XI debtor, thereby enhancing its prospects for rehabilitation. *Id.* at 687.

In dealing with the issue of Chapter XI interest, the Court was clearly addressing the situation of an operator of a private business who lacked any legal justification for the nonpayment of federal payroll taxes and federal excise taxes on its business receipts.[7] The premises on which this Court viewed the allow-

[7] These taxes vary with and reflect the debtor's economic activity during the Chapter XI proceeding. In this respect they are unlike the real estate taxes in the case at bar which are assessed automatically and bear no relationship to the Trustees' business activity.

ability of interest accruing during a Chapter XI case are clearly not applicable in the case of a railroad reorganization proceeding.

In Chapter XI cases, businesses are run by debtors-in-possession or trustees for the benefit of creditors and stockholders. There is absent any overriding public interest in respect of the operation of the business. A default in the payment of a postpetition tax in such circumstances can serve only private interests and not public interests. When a debtor does not pay, it is usually not as a matter of the necessary protection of the public interest. However, in railroad reorganization proceedings, trustees are obligated to continue rail service in the public interest and may lawfully defer the payment of taxes if necessary to accomplish that end.

The fundamental distinction between the two types of proceedings has been noted in *In re Penn Central Transportation Co.*, 458 F.Supp. 1234 (E.D. Pa. 1978), *aff'd*, 596 F.2d 1102 (3d Cir. 1979):

> In ordinary corporate reorganizations, the continued operation of the Debtor while reorganization planning is taking place is conducted primarily for the benefit of its creditors. Any debtor which cannot even meet its current operating expenses while being temporarily relieved of the burden of pre-bankruptcy debt is not likely to remain in reorganization very long; it will be liquidated. Hence, the possibility of any significant amount of postpetition taxes remaining unpaid does not ordinarily arise.
>
> Railroad reorganizations differ from ordinary corporate reorganizations because of the public interest in continued rail service. Bankruptcy liquidation is not available to railroads. A railroad debtor simply must continue to operate, without regard to the interests or desires of its creditors, at least until such time as the constitutional rights of secured creditors under the *Brooks-Scanlon* line of cases are clearly in jeopardy.

Id. at 1277.

Unfortunately, it has been the history of most railroad reorganizations that the public interest in the continued operation of a railroad requires the deferral of taxes in order to pay the immediate costs and expenses necessary to maintain and preserve operations. As stated by Judge Fullam:

> Indeed, it can fairly be stated that deferral of taxes is the rule rather than the exception in railroad reorganizations. See, e.g., *In re Long Island Railroad Co.*, 114 F.Supp. 363 (E.D.N.Y. 1953); *In the Matter of the New York New Haven and Hartford Railroad Co., Debtor* (D. Conn. Civil Action No. 30226), Order No. 54 entered January 5, 1962; Memorandum of decision in support of Order No. 25, filed October 20, 1961).
>
> . . . .
>
> Just as the public interest in the continued operation of the railroad is, within the limitations imposed by the Constitution, paramount over private interests, so also, when it becomes necessary to choose between the two, the public interest in the continued operation of the railroad is paramount over the payment of taxes.

In re Penn Central Transportation Co., 325 F.Supp. 294, 299-300 (E.D. Pa. 1970), *aff'd*, 452 F.2d 1107 (3rd Cir. 1971), *cert. denied*, 406 U.S. 944 (1972).

In the case at bar, the Trustees had to defer the payment of postpetition taxes if they were to perform their statutorily-mandated obligations. Unlike the situation in *Nicholas*, the non-payment was lawful; and the City does not now contend otherwise. Indeed the deferral was approved and authorized by the Reorganization Court. In these circumstances, the non-payment of postpetition taxes is properly viewed as resulting from the law's delay. That view is in accord with the teaching of this Court in *Vanston Bondholders Protective Comm.* v. *Green*, 329 U.S. 156 (1946), a case in which default interest had accumulated as a consequence of a court-authorized deferral of payment of bond coupons.

> Exaction of interest, where the power of a debtor to pay even his contractual obligations is suspended by law, has been prohibited because it was considered in the nature of a penalty imposed because of delay in prompt payment — a delay necessitated by law if the courts are properly to preserve and protect the estate for the benefit of all interests involved. . . .
>
> . . . .
>
> . . . In fact, both Inland and the receiver were ordered by the court not to pay the coupons on the dates they were, on their face, supposed to have been paid. The contingency which might have created a present obligation to pay interest on interest — *i.e.*, a free decision by the debtor that it would not or could not pay simple interest promptly—was prohibited from occurring by order of the court. That order issued for a good cause, we may assume: to preserve and protect the debtor's estate pending a ratable distribution among all the creditors according to their interests as of the date the receivership began. The extra interest covenant may be deemed added compensation for the creditor or, what is more likely, something like a penalty to induce prompt payment of simple interest. In either event, first mortgage bondholders would have been enriched and subordinate creditors would have suffered a corresponding loss, because of a failure to pay when payment had been prohibited by a court order entered for the joint benefit of debtor, creditors, and the public. Such a result is not consistent with equitable principles. For legal suspension of an obligation to pay is an adequate reason why no added compensation or penalty should be enforced for failure to pay.

Id. at 163, 166-167. Just as the court order in *Vanston* suspended the obligation to pay bond coupons and prevented accrual of default interest required under the contract with the bondholders, so too did the lawful deferral of postpetition

tax payments in the case at bar suspend the obligation to pay those taxes and prevent the accrual of postpetition interest on those taxes.[8] As a consequence of the lawful suspension of the obligation to pay, no allowable interest claim could arise. *Nicholas* involved no lawful suspension of the obligation to pay Chapter XI taxes.

Also, the taxing authority in *Nicholas* received no benefit from the non-payment of taxes. In the case at bar the taxing authorities received a substantial benefit as a consequence of the deferral. Indeed the deferral was necessitated by the interest of the public, as represented by the City and the other municipalities served by the railroad, in the continuance of railroad operations. Had there been no deferral, the Trustees would not have had sufficient funds with which to continue rail service. Simply, the railroad would have shut down. If that had come to pass, the City and the other taxing authorities would have complained and fought for a resumption of operation in order to avoid the consequent loss to their tax base and the damage to shippers, consignees and the general public located within their jurisdictions. Instead, because of the deferral and continued rail operations, the City and the other municipalities were able to continue to tax the property of businesses served by the railroad at their highest and best use and to enjoy the substantial economic benefits accruing as a result of the availability of railroad freight and commuter service to their inhabitants. It is more than ironic that as a representative of the public interest benefited by the deferral, the City should seek to realize the additional benefit of default interest accruing as a consequence of that deferral. Whether that partakes of having one's cake and eating it too, we leave to others. What is clear is that circumstances such as these were not present in *Nicholas*.

---

[8] In this connection we note that the postpetition interest which the City seeks in this case is of a similar nature to the interest on interest which was the subject of *Vanston*. Each arises only as a consequence of a default in payment and is a tool to discourage such default. Each is in the nature of a penalty for non-payment.

In addition to the foregoing distinctions, it is quite clear that this Court's analysis of the various stages of bankruptcy set forth in *Nicholas* applies only to private businesses and not to railroads. As the Court of Appeals noted, liquidation bankruptcy is not available to a railroad. (P. App. 20). See *Continental Illinois National Bank & Trust Co.* v. *Chicago, Rock Island & Pacific Railway Co.*, 294 U.S. 648, 671-672 (1935). Typically, a railroad reorganization proceeding combines features characteristic of both a reorganization and a liquidation bankruptcy, albeit that the liquidation aspects are, hopefully, in aid of reorganization. Thus railroad lines may be abandoned under § 77(c)(6) and property sold under § 77(o). The abandonment of lines necessitates an inquiry into the public interest affected thereby. The Railroad's reorganization proceedings involved such abandonments of lines and the sale of substantial commuter line properties. The accomplishment of these "liquidations" necessarily consumed substantial time. Thus, as a consequence of the very nature of these proceedings, a postpetition creditor of a railroad, and particularly a taxing authority, can reasonably expect "meaningful legal delays" affecting the payment of its claim in the reorganization proceeding. Such delays, which are not typical in a Chapter XI case, require the disallowance of interest in § 77 proceedings if creditors are not to be disadvantaged by the delay.

On the basis of distinctions similar to those above set forth, Judge Anderson in *In re New York, New Haven and Hartford Railroad Co.*, 304 F. Supp. 1121, 1134 (D. Conn. 1969), viewed this Court's decision in *Nicholas* as not inconsistent with the non-recognition of interest on postpetition taxes in a railroad reorganization proceeding, where the deferral of the payment of taxes was necessary to permit the continued operation of the railroad. In denying any allowance of interest on postpetition secured and unsecured taxes, Judge Anderson stated:

> Its [*Nicholas*'] holding that taxes incurred during a Chapter XI proceeding itself will carry interest was based upon the fact that delay in payment was brought about as a result of the debtor's own request that it be given a chance to rehabilitate itself and not because of the "law's delay." . . . The sole purpose of pursuing a § 77 reorganization under the court's order, was to seek a means of keeping the New Haven in operation in the public interest. The delay was imposed upon the debtor's estate in this fashion and for this purpose. The ordered accumulation of accrued but unpaid taxes, as well as the interest on them, was not directed by the court as a matter of administrative convenience but as a matter of necessity. *Nicholas* gives recognition to and reaffirms the principle that the bankrupt estate should not be disadvantaged by means of the 'law's delay'.

Id. at 1134.

Because of the differences above described, *Nicholas* does not require a result different from that determined below and provides no basis for the grant of certiorari.

C. *The Court of Appeals Properly Affirmed the Reorganization Court's Disallowance on Equitable Grounds of the City's Claim for Postpetition Interest.*

In its Petition for Certiorari, The City contests the Reorganization Court's assessment of the pertinent equities. That argument does not support a grant of certiorari.

The Court of Appeals ruled that the Reorganization Court's factual findings in support of its order were not clearly erroneous. The City does not challenge those findings in its Petition. Nor, as previously noted, does it now claim that the deferral of postpetition taxes was wrongful. Instead it appears to argue matters which are either not in the record or which

are not supported by the record. It asserts that it furnished the railroad with essential municipal services. Nothing in the record supports that statement. On the contrary, the record shows that a good portion of the taxes were assessed on vacant land and that though no taxes were assessed on residential property (which might be a burden on or be benefited by the City's schools), approximately 40% of the taxes assessed were assessed for schools. In fact, the nature of municipal real estate taxes is such that they reflect or measure neither services rendered to the estate nor the demands made on the municipality by the estate. No mention is made by the City of the benefits accruing to it and its residents from the continued operation of the railroad made possible by the deferral of tax payments.

The City also alleges that the deferral "has resulted in harsher treatment for the City than that accorded other administrative creditors who have been paid currently." As noted by the Court of Appeals, there is nothing in the record that establishes that all administrative creditors have been paid currently or that those who have been deferred will receive interest. (P. App. 24). Under the Plan no administrative creditor is to receive interest.

Next the City suggests that it suffered loss as a result of the deferral and adopts the view of Chief Judge Campbell in his partial dissent that it was forced to make an interest-free loan. Again, nothing in the record establishes that the City suffered any loss other than the non-receipt of its default interest. There is no evidence in the record that the deferral resulted in decreased services, increased costs, increased taxes or any other burden. If one were to adopt the view that its default interest accrued notwithstanding the suspension of the obligation to pay the taxes, the most that the City would have lost is that default interest. As previously discussed, that is not interest which was bargained for as the consideration for monies loaned. In fact, the Trustees cannot be said to have received any loan from the City. While revenue which otherwise might

possibly have been distributed to the City had to be distributed to employees and suppliers of goods and services necessary to maintain operations, the City itself was the beneficiary of such distribution, as discussed on page 16, *supra*. Moreover, that deferral has enabled the City to be paid, without sacrifice to the public interest in continued rail operations, the full amount of its postpetition taxes and its prepetition taxes, amounts which, on the basis of the record, appear to exceed the value of services actually provided by the City to the estate. On the record it was reasonable to conclude that those tax payments and the benefits of continued railroad freight and commuter service more than offset the non-receipt of default interest.

If one were to adopt for the benefit of the City the analogy to a loan, it would be difficult not to adopt that analogy for the benefit of all other postpetition creditors of the railroad who have not been paid in a timely fashion. That would subject this estate and other estates in railroad reorganization proceedings to numerous and substantial claims for postpetition interest, all no doubt at varying interest rates. The results would be an administrative nightmare and substantial prejudice to all creditors, results which this Court has historically sought to avoid by denying postpetition interest. See e.g. *Nicholas*, at 682; *Vanston Bondholders Protective Comm.* v. *Green*, 329 U.S. 156, 164 (1946). Accordingly, the loan analogy is not well-founded and should be rejected.

Lastly, the City asserts that it has disproportionately borne the costs of reorganization and that it is unfair to deny it postpetition interest when mortgage bondholders are receiving their contract interest. The benefits which the City has received and the burdens and sacrifices sustained by the other creditors do not support this assertion.

As noted by the Court of Appeals, the City has conceded that if postpetition interest were to be paid on its tax claims, general unsecured creditors would receive CCI's, but no cash in satisfaction of the 10% of their claims that those creditors

are to receive under the Plan. (P. App. 23). At the end of five years, those CCI's may be valueless. Furthermore, the City ignores the sacrifice made by the mortgage bondholders as a consequence of the reorganization proceeding. Those bondholders never had the interest or stake in the continued operation of the railroad that the City and the other municipalities had. Their collateral was sufficient to cover the principal of the debt owed to them and their contract interest. Had there been no deferral of taxes and railroad operations had ceased, they would have realized on their collateral at an early stage of the proceeding, and would have been free to reinvest the proceeds of their full recovery to yield a market rate of return substantially in excess of the contract rates they are receiving under the Plan. Additionally, while the bondholders were being delayed in their recovery, proceeds of the sale of a part of their collateral were used to pay necessary costs of rail operations. They thereby contributed to the benefits which accrued to the City and other municipalities as a consequence of that operation, without themselves realizing any benefit from such operation. Under the Plan they will receive the principal and interest which they would have received years earlier had there been no deferral. The interest they will receive is the bargained-for consideration for loans actually made, the sole compensation for monies advanced by them. That they are to receive such interest while the municipalities are denied default interest can in no way be said to be inequitable in the circumstances of this case.

In light of the record in this case, the Court of Appeals properly found no basis for reversing the Reorganization Court's disallowance, on equitable grounds, of the municipalities' claim for postpetition interest. Thus the grant of certiorari would not be appropriate.

D. *The Court of Appeals Properly Affirmed the Reorganization Court's Ruling That the Plan's Denial of Postpetition Interest Did Not Violate the Absolute Priority Rule or Principles of* Fosdick v. Schall.[9]

The absolute priority rule "controls the *payment* of allowable interest, not the determination of what interest is allowable." *In re New York, New Haven and Hartford Railroad Co.*, 4 B.R. 758, 799 (D. Conn. 1980) (footnote omitted; emphasis in original). It is a rule that requires the distribution to senior creditors of the full value of allowable or enforceable claims before junior creditors may participate. *Consolidated Rock Products Co.* v. *DuBois*, 312 U.S. 510 (1941). Having properly determined that there was no allowable claim for postpetition interest under the circumstances of this case, there existed no allowable or allowed claim which was wrongfully subordinated in violation of the absolute priority rule.[10]

The same analysis requires the rejection of the City's argument in respect of *Fosdick* v. *Schall*. Additionally, that rule subordinates the mortgagee's interest in the railroad's income only to the claims of certain suppliers of goods and services which are indispensable to the continued operation of the railroad. *In re Boston and Maine Corp.*, 634 F.2d 1359, 1368 (1st Cir. 1980), *cert. denied*, 450 U.S. 982 (1981). While it is at best doubtful that the principal amount of municipal taxes would qualify for such priority, it is quite clear that interest thereon would not qualify.

---

[9] 99 U.S. 235 (1879).

[10] The Reorganization Court's decision was also sustainable as an equitable subordination of the postpetition interest claim to the claims of other creditors under the Plan.

II. The Petition Does Not Present an Issue Likely To Recur.

The primary issue raised by the Petition, the alleged conflict between *Nicholas'* allowance of postpetition interest on postpetition taxes in a Chapter XI case and the Reorganization Court's disallowance of such interest, is not an issue likely to recur.

In 1978, Congress adopted the new Bankruptcy Code and repealed the Bankruptcy Act. Pub. L. No. 95-598, 92 Stat. 2549, *et seq.* Section 503 of the Bankruptcy Code, 11 U.S.C. §503 (1978), which, at least for purposes of Chapter 11 and liquidation bankruptcy cases, governs payment of administrative expenses such as taxes, provides in pertinent part:

> (a) An entity may file a request for payment of an administrative expense.
>
> (b) After notice and a hearing, there shall be allowed, administrative expenses, other than claims allowed under section 502(f) of this title, including—
> (1)(A)...
> (B) any tax—
> (i) incurred by the estate,...
> ....
> (C) Any fine, penalty or reduction in credit, relating to a tax of a kind specified in subparagraph (B) of this paragraph;...

Nothing in § 503 specifically provides for the payment of interest on unpaid taxes, and the legislative history indicates an intention that interest not be allowed as an administrative expense. In *In re Stack Steel & Supply Co.*, 28 B.R. 151, 155-6 (Bkrtcy. W.D. Wash. 1983), Bankruptcy Judge Treadwell held, on the basis of that legislative history, that § 503 does not provide for postpetition interest on postpetition tax claims in a Chapter 11 case:

The legislative history of § 503(b)(1)(B) indicates that the Senate desired administrative priority for interest on taxes[9] and that S.2266 passed by the Senate on September 7, 1978 specifically provided for this. But earlier, the version of H.R. 8200 passed by the House on February 1, 1978, omitted any reference to interest on taxes, and provided only that taxes on, measured by, or withheld from wages, salaries or commissions attributable to the post-petition period would be administrative expenses. Code § 503(b)(1)(B), as finally enacted, omits any reference to interest on taxes as being accorded administrative priority. The legislative history addressing the compromise bill is silent as to why the Senate's specific provision for interest was omitted. 124 Cong. Rec. H. 11,094-5 (Sept. 28, 1978); S 17,411 (Oct. 6, 1978). Because § 503(b)(1) adopts the approach taken in the House bill as modified by some provisions contained in the Senate amendment, it is a plausible inference that the omission of the words "including interest thereon" from the language "any taxes, including interest thereon" as set forth in § 503(b)(1)(B) of S.2266 was deliberate and significant. This Court does not think that the omitted words were surplusage, and notes that substantial discussion had been addressed to the issue of post-petition interest and penalty on taxes under the former Bankruptcy Act. *See* e.g. *Nicholas* v. *United States*, 384 U.S. 678, 86 S.Ct. 1674, 16 L.Ed.2d 853 (1966) (taxes incurred in Chapter XI proceeding itself, accrue interest, except the accumulation of interest is suspended if a petition in liquidation is filed); *In re International Power Securities Corp.*, 109 F.Supp. 544 (D.N.J. 1953) (trustee is liable not only for the principal amount but also the interest thereon where, under the provisions of local law, such interest is assessable against taxpayer upon his failure to pay

[9] See S. Rep. No. 989, 95th Cong. 2d Sess. 66 (1978)

> the tax within the time prescribed). Accordingly, the claim . . . for interest on personal property taxes assessed after the filing of the debtor's Chapter 11 petition is denied.

Id. at 156 (footnote in original).

This reasoning and conclusion were adopted by Judge Young in *In re H&C Enterprises*, 35 B.R. 352 (Bkrtcy. D. Idaho 1983).

Thus, the language of § 503 and the analysis of its legislative history indicate that Congress has changed the result in *Nicholas* for cases governed by the Bankruptcy Code.

Conclusion

For the reasons hereinabove set forth and, more particularly, since the decision below does not conflict with *Nicholas* and is supported by the facts and a reasonable assessment of the pertinent equities, this is not an appropriate case in which to grant a writ of certiorari.

Respectfully submitted,

ROBERT W. MESERVE and
BENJAMIN H. LACY
Reorganization Trustees

By Their Special Counsel

ROBERT M. GARGILL
Counsel of Record
JOHN N. GARNER
CHOATE, HALL & STEWART
60 State Street
Boston, Massachusetts 02109
(617) 227-5020